

CONSIDERATIONS REGARDING THE JAPANESE TAX SYSTEM

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Abstract

In the 21st century the structure of the Japanese socio-economy is changing greatly because of the rapidly aging society and married couples having a smaller number of children, diversified life styles and globalization of the country. To sufficiently respond to these various structural changes and to realize sustainable activation of the socio-economy, it is considered necessary to execute toward the construction of a desirable tax system based on medium to long-term viewpoints.

This paper presents the main points of the tax reforms and the characteristics of the main taxes in Japan.

In the tax reform in 2003, the first step of the reform toward the construction of “a desirable tax system” on corporation tax should be taken so that a sustainable socio-economy may be activated. Inheritance and gift taxes should be unified to achieve integration. Thus, measures such as the increased tax reductions for R&D and investment in plant and equipment to support growth of strategies to innovate in the 21st century and unification of the inheritance and gift taxes to help smooth transfer of assets to the next generation are taken.

In the Fiscal Year 2006 tax reform, in a continuous effort to implement a “desirable tax system”, a major transfer of source of tax revenue in personal income taxes from the individual income tax to inhabitants taxes, amounting to 3 trillion yen, was conducted as part of the trinity reform. Also the proportional tax credit, which had been in place since 1999 as a temporary and exceptional measure to boost the economy, was abolished in light of the economic recovery.

In corporation taxes, R&D-related taxation was revised to promote private research and development activities, and a new system was established to strengthen the information infrastructure and to increase competitiveness.

Current taxes levied by national and local governments in Japan can be classified into three groups: taxes on income; property, etc. and consumption.

1. Taxes on Income:

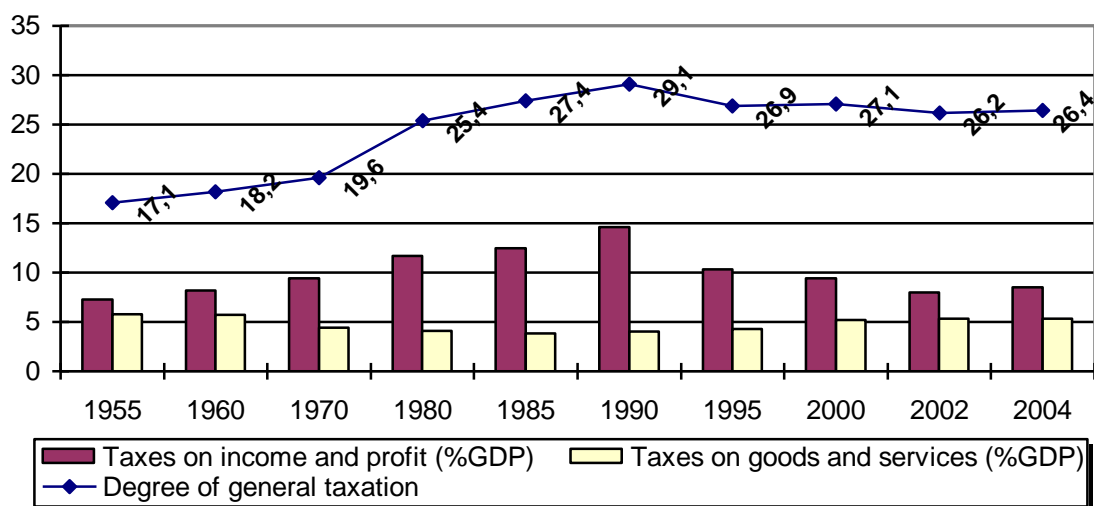
- a. National Taxes: Income Tax (Individual Income Tax) and Corporation Tax (Corporate Income Tax);

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- b. Local Taxes: Prefectural Inhabitants Tax, Municipal Inhabitants Tax and Enterprise Tax;
- 2. Taxes on Property, etc.:
 - a. National Taxes: Inheritance Tax, Gift Tax, Land Value Tax, Registration and License Tax and Stamp Tax;
 - b. Local Taxes: Automobile Tax, Mine-lot Tax, Property Tax, Light Vehicle Tax, Special Landholding Tax, Business Office Tax, urban Planning Tax and Real Property Acquisition Tax;
- 3. Taxes on Consumption
 - a. National Taxes: Consumption Tax, Liquor Tax, Tobacco Tax, Special Tobacco Tax, Gasoline Tax, Local Road Tax, Liquefied Petroleum Gas Tax, Motor Vehicle Tonnage Tax, Aviation Fuel Tax, Petroleum and Coal Tax, Promotion of Power-resources Development Tax, Customs Duty, Tonnage Due and Special Tonnage Due;
 - b. Local Taxes: Local Consumption Tax, Prefectural Tobacco Tax, Golf Course Utilization Tax, Automobile Tax, Municipal Tobacco Tax, Light Vehicle Tax, Bathing Tax, Hunter's Tax, Automobile Acquisition Tax, Light Oil Delivery Tax and Mineral Products Tax, etc.

The degree of general taxation, in Japan, measured as total tax revenues as percentage of GDP, represents, in current period, about 26%, on the decrease after '80-'90.

Figure no 1: Degree of general taxation in Japan



Taxes on Income

a. Characteristics of Japan's Income Tax

The individual income tax and the corporation tax (corporate income tax) are treated separately under the Income Tax Law and the Corporation Tax Law, respectively.

Taxable individual income, unlike corporate income, is computed on a calendar year basis, from 1 January through 31 December.

Under the Income Tax Law, taxable income is classified for the purpose of calculation into the following ten categories in accordance with the nature of the income, taking into consideration the capacity for taxation as well as the convenience of calculation:

- interest income;
- dividend income;
- real estate income;
- business income;
- employment income;
- retirement income;
- timber income;
- capital gains;
- occasional income;
- miscellaneous income.

Income tax is to be assessed primarily on the basis of an individual's aggregate income, regardless of its category. Individual taxpayers must pay income tax on the total income earned during the calendar year concerned.

Retirement income and timber, however, are taxed separately from the other categories of income under the Income Tax Law. Interest income is taxed separately from the other categories of income under the Special Taxation Measures Law. Dividend income and capital gains etc. are, or may be, taxed separately as well.

Income tax due is calculated applying tax rates to ordinary taxable income, taxable retirement income, or taxable timber income¹.

Table no 1: Individual Income Tax Rates (From Fiscal Year 2007)

Taxable Income (A)	Tax Rate (%) (B)	Cumulative Tax for Each Bracket (C)
< Y 1,950,000	5	-
Y 1,950,000 – Y 3,300,000	10	Y 97,500
Y 3,300,000 – Y 6,950,000	20	Y 232,500
Y 6,950,000 – Y 9,000,000	23	Y 962,500
Y9,000,000 – Y 18,000,000	33	Y 1,434,000
> Y 18,000,000	40	Y 4,404,000

Note: Tax liability is obtained by multiplying the excess amount (A) by the rate (B) and adding the amount (C). For example, income tax due on taxable income of Y 10 million is:

$$(Y\ 10,000,000 - Y\ 9,000,000) * 0,333 + Y\ 1,434,000 = Y\ 1,764,000$$

Taxpayers with respect to income tax are divided into resident taxpayers and nonresident taxpayers.

An individual who has a “Jusho” (domicile)², or has had a residence for one year or more in Japan must pay income tax on all of his income from both within and outside Japan. A resident who doesn’t have the Japanese nationality and who has had domicile or residence in Japan for no more that five years in the past ten years, however, is subject to tax on the total income derived from sources within Japan and on the income from other source paid in Japan or remitted to Japan from abroad.

An individual who has no Jusho and has had residence in Japan for less than one year must pay income tax on his income from sources within Japan.

For the determination and payment of taxes due, income tax is assessed under the self-assessment system, under which income tax liability is determined by the taxpayer’s declaration based on proper records of the tax base and the tax amount due, and payment is made on this basis. In the event a taxpayer fails to file a correct return, the tax authority makes an assessment through examination and conducts “correction” or “determination”. Almost all wage and salary earners,

¹ If a taxpayer has income from the sale or transfer of timber, such taxable income is divided by five and the amount of tax due an that amount is multiplied by five to obtain the total tax due.

² An official of the national or local government of Japan who resides abroad to have a “Jusho” in Japan for the period when he does not have a domestic ‘Jusho’

however, are not required to file final return, owing to the withholding system and year-end adjustment system.

A withholding system is frequently used. For the convenience of tax collection, a withholding mechanism requires the payer of the following categories of incomes to compute the amount of income tax, deduct that amount at the time of payment, and transmit it to the government:

- interest income;
- dividend income;
- profit from redemption of discount bonds;
- employment income;
- retirement income;
- miscellaneous income from public annuities, etc.;
- fees or other remunerations for certain services, such as writing or speeches, and the services of lawyers, movie actors, professional baseball players, etc.;
- income from business that provides the personal services of artists and public entertainers;
- contract deposits received by professional baseball, etc. for services to be rendered, prizes for advertising purpose, and prizes received by owners of racehorses;
- annuity from life insurance contract;
- quasi-financial products;
- distribution of profits from anonymous association.

b. Characteristics of the Japanese Corporation Tax

Under the Corporation Tax Law, corporate income tax is levied on the taxable income of corporations. The Special Taxation Measures Law provides certain special measures for specific policy objectives.

Corporations for tax purposes include not only those corporations in an ordinary sense, but also all types of juridical persons under various names such as cooperatives, public corporations, social welfare juridical persons, labor unions, and so forth. Organizations without juridical personality, such as unincorporated clubs or associations, are regarded as juridical persons for tax purposes so long as they designated representatives or managers.

Corporation tax is levied on the income of each accounting period³, income in liquidation, or in case of trust and insurance companies, Japan Mutual Aid Agricultural Co-operation (Zen-Kyo-Ren), etc., dealing with the Welfare

³ In Principle, taxable income is calculated according to the GAAP (Generally Accepted Accounting principle)

Pension Fund Plan, defined benefit pension plan asset management contracts, etc., the remaining balance of the retirement pension surplus reserve at the beginning of each accounting period. In the case of a family corporation, an additional tax is levied on the retained profits for each accounting period when these profits exceed a certain prescribed level.

Unlike the individual income tax, no preferential treatment is allowed for capital gains in computing taxable corporate income. Sales of the land are treated specially according to the holding period stipulated in The Special Taxation Measures Law. (This rule is not applied from January 1, 1998 to December 31, 2008)

Since the overall reform of the taxation system in 1950 that followed the Shoup Recommendations, the corporation tax system has been in principle based on the notion that a corporation is an aggregate of shareholders and that these should be an integration of tax burdens, though the method of mitigating tax burden has changes somewhat over the years.

In the early years, the alleviation of tax burdens was done wholly at the shareholder level. The corporation's taxable income was taxed at 35% whether it was distributed or not. The dividends received by an individual shareholder were included in this taxable income together with income from other sources. Dividends received by a corporation were included in the taxable income for a corporation due to tax purpose.

In 1961, a split-rate system was introduced in order to increase the equity capital of the corporation vis-à-vis borrowed capital. The underlying philosophy of the tax reform was to implement the mitigation partly at the company level and partly at the shareholder level. The tax rate on distributed profits was reduced from 38% to 28%, while the tax on undistributed profits remained at 38%. Correspondingly, the dividend credit with respect to income tax was reduced from 20% to 15% of the dividend received. It was subsequently stipulated that in case where the dividends received by a corporation exceeded those distributed, a quarter of the balance should be included in the taxable income of the corporation.

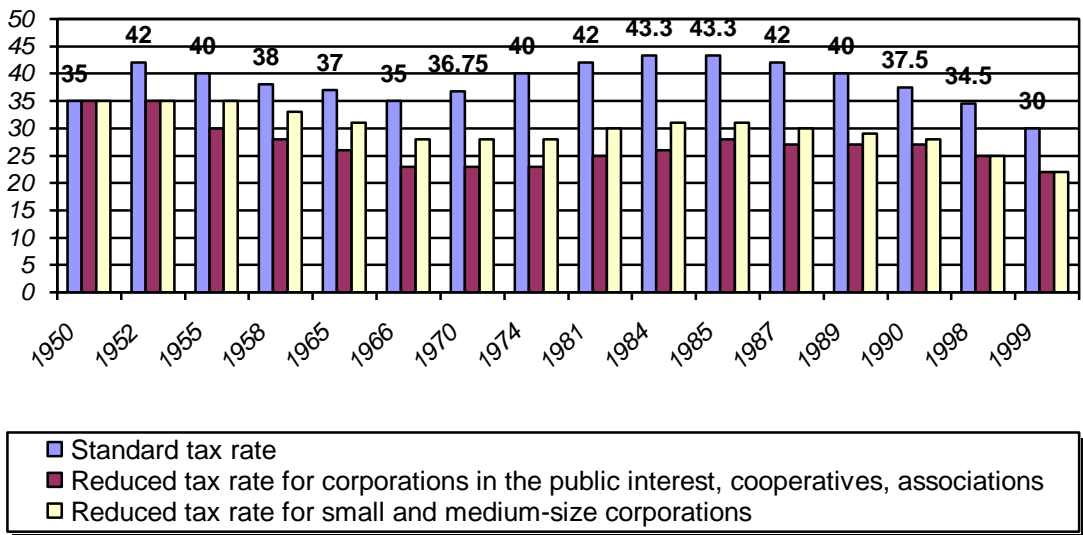
There have been some changes in tax rates since that point, but the basic structure of corporate taxation system remains unchanged.

In recent years, there have been various arguments about the corporate taxation system. In the tax reform of 1989, the reduced tax rate on distributed profits (which was 32% while the tax rate on retained profits was 42%) was abolished and a rate of 37.5% was applied to both retained and distributed profits from 1 April 1990.

The present tax rate is 30%, applied after 1 April 1999.

For corporation with capital of no more than Y100 million, reduced tax rates are applicable for income of no more than Y8 million. The tax rate became 22% after 1 April 1999. In addition, for public service corporations and cooperative associations a reduced rate of 22% is applied.

Figure no 2: Trends of corporation tax rates

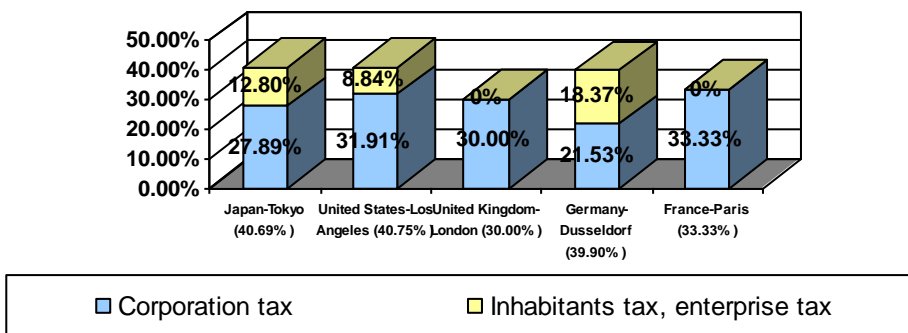


Corporation tax is paid under the self-assessment system. A corporation must file a corporation tax return, together with a balance sheet and a statement of profit and loss, to the Director of the Tax Office, in principle, within two months of the end of each accounting period, and must pay the tax as reported on the return. If taxpayers fail to file correct returns, tax authorities reassess returns through a procedure of correction or determination.

Local income taxes, which are local inhabitant tax and enterprise tax, are also imposed, by the local authorities, on corporate income.

The resulting effective corporate income tax rate for companies subject to the 30% rate is approximately 41% (42% if the head office is located in Tokyo).

Figure no 3: International comparison of effective corporate income tax rate⁴



For fiscal years beginning on or after 1 April 2004, Business Scale taxation (Gaikai Hyojun Kazei) applies to companies with a capital of more than Y 100 million. Under the Business Scale Taxation, a corporation is subject to tax on the basis of its added value, its capital amount and its taxable income. Under Business Scale Taxation for certain corporations, the effective rate will be reduced to approximately 40%.

General Consumption Taxes

Consumption tax is an indirect tax fairly and widely imposed on general consumption. In domestic transactions, taxpayers are business enterprises offering asset transfer, loans and services for consumption and these who receive foreign goods from bonded areas. Consumption tax is added on to the price of goods and services offered by enterprises and ultimately borne by consumers. Since this tax

⁴ The effective tax rate for each city takes account of the effect that the amount of the local taxes may be deductible in calculating national taxes etc.

Tokyo's Corporation Enterprise Tax uses a tax that is applied to corporations with capital of 100 million or over that are subject to pro forma standard taxation. It should be mentioned that an added value percentage and capital percentage are also levied.

Some cities in the United States levy a municipal corporation tax. The effective tax rate in New York, for example, is 45.95% when federal taxes, state taxes (7.5%, surtax [17% of tax amount]), and city taxes (9.95%) are combined. In addition to corporate income tax, a tax is also imposed on wages paid in some states and cities.

Germany's corporate tax is a joint federal-state tax (50:50); the surtax is a federal tax. The trade tax is a municipal tax, a tax is also calculated by multiplying a tax rate that varies with municipality (450% in Dusseldorf) by 5% of business profits.

France's effective tax rate is 34.43% when the social tax on corporate profits (3.3% of the corporate tax payment) is included. An estimated corporate tax and business tax (local tax) is also imposed in addition to the corporate income tax.

The figure for countries other than Japan are based on their tax systems of July 2006.

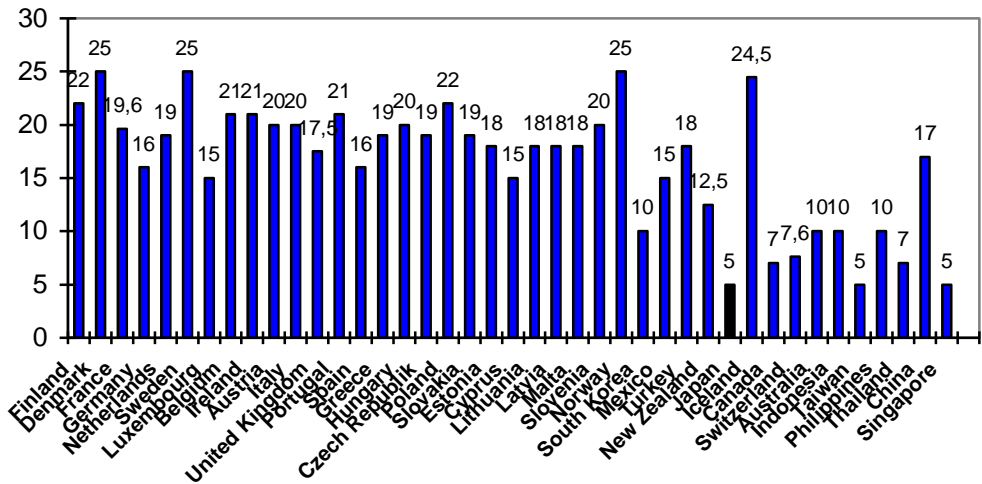
is assessed on transactions by enterprises at each manufacturing, wholesale, and retail stage, it contains a scheme for avoiding tax accumulation by way of deducting taxes on purchases, thus making it neutral to industry and the economy in general.

The tax period for the calculation of tax payable on domestic transactions is for individual proprietors, the calendar year which overlaps with the tax period for their income tax returns, and for corporations, the accounting period which overlaps with their corporate tax returns. Calculation of the deductible consumption tax on purchases is based on both book entries and invoices or delivery statements currently in use instead of invoices.

For small and medium-sized business enterprises, a simplified taxation system is utilized to alleviate the administrative burden an tax payers, thereby enabling calculation of the tax amount from the sales amount.

The rate of tax is a flat 4% (together with the 1% local consumption tax, a local tax, the tax rate reaches 5%). Various amendments were rendered in 1991 notably on the scope of exemption and on the simplified taxation system, which was followed by amendments in 1997 for the introduction of the current flat rate of 4% and abolition of the special deduction system for small and medium-sized enterprises.

Figure no 4: International comparison of value-added tax rates (standard tax rate)⁵



Note: The figures for countries other than Japan are based on their system of January 2006

⁵ In Canada, in addition to Goods and service tax (value-added tax), taxes such as a retail sales tax are imposed by almost provinces (Example: 8% in Ontario). In the United States, state, country and city sales taxes are imposed (Example: New York City 8.375%). EC Directives provide that the standard rate should be 15% or more in EU member nations.

While taking into account the current economic and fiscal environment, the FY2007 tax reform fundamentally revise the depreciation system from a viewpoint of establishing the basis for growth of the economy and take measures in this areas including taxation of SMEs, international taxation, taxation of corporate reorganization and trust, taxation of financial assets and stocks, taxation of housing and land, and improved environmental for tax payment.

The general account budget for FY 2007 totaled 82,908.8 billion yen revenues, where tax revenues was projected of 53,467 billion yen, non-fiscal revenues of 4,009.8 billion yen and government bond issues of 25,432 billion yen.

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